THE EVOLUTION OF THE HOUSING FINANCE POLICY IN HUNGARY: 1993-1999

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INTRODUCTION

This report summarizes the discussion of developments in housing finance policy in Hungary that were prepared over the period of 1994 to 1999. The original reports were intended to inform USAID officials about developments in this area of concern. They were generally created every 6 months, following interviews with relevant officials and analysis of recent developments.

This summary is structured around the same topics addressed in the original reports. This structure originally reflected both the policy preconditions agreed to for implementation of the proposed USAID Housing Guarantee (HG) program (Conditions Precedent) and the dimensions of policy and market conditions that would have been taken as barometers of success of that program.

It is intended that this report provide convenient access to the substance of those semi-annual reports and a guide in English to many of the major policy developments in this area over this period.

Housing Policy Statements

One of the Conditions Precedent of the proposed HG Program was that a housing policy statement be adopted by the Government of Hungary (GOH) that was consistent with the policy goals of the HG. These policy goals had been under discussion between the GOH and USAID since 1992 and these discussions were reflected in the policy resolution adopted by the previous government in May 1993, Resolution 1038/1993.

This Resolution set up a working committee called the Inter-ministerial Committee on Housing Policy, involving five different Ministries and the National Bank of Hungary. This Committee was charged with developing policy on a coordinated basis between the affected ministries. The Resolution specified a number of areas in which analysis and policy formulation was needed. This Committee was particularly useful as a forum for developing policies and statutes designed to reduce the credit risks of mortgage lending, a critical issue in need of intra-government cooperation.

The new government in May 1994 initially pursued policies consistent with Resolution 1038/1993. However, in August 1995, it created a new body called the Housing Policy Council to develop housing policy. In addition to the relevant Ministries, the Council included representatives of the banks, interest groups, and local governments. The Ministry of Finance was made responsible for housing policy for the government as Chairman of the Council and the Ministry was responsible for the operation of the Council. One of the first activities of the Council was the formulation of a new housing policy resolution by the government.

The new Housing Policy Concept was more articulate and sophisticated with respect to the goals and tools of housing policy. In fact, it was as clear and "level-headed" as possible for a political document of this nature. It was also consistent with two of the key goals of the HG, rationalizing housing subsidies and targeting them.

The new Concept was also more focused on the goal of establishing the ability of borrowers to effectively offer their houses as collateral. It is stated that undue difficulty of foreclosure and eviction ultimately denies citizens the ability to conclude a contract with a lender that is advantageous to both parties.

However, the Concept specified some actions that raised concerns. These included requests for detailed proposals for (1) legislation for a mortgage bond, (2) legislation for a Bauspar system, (3) an analysis of a loan guarantee institution, and (4) an analysis of an savings and loan-type of institution. These indicated that the government was edging toward institutional interventions into housing finance, which could be inefficient and distortive. This was clearly the case with respect to the Bauspar proposal, which was already in an advanced stage, about to go to the Parliament. More serious was the potential for the government to sponsor a guarantee institution or savings bank that relies excessively on implicit or explicit government guarantees. These policy areas then became the focus of USAID technical assistance (TA) in an effort, ultimately successful, to educate the GOH about the perils of such interventions.

Also of interest was the government's stated intent of expanding the potential for property taxes as a source of local revenues and of statistically tracking the housing-related activities of local governments. The Concept states the principle that local housing subsidies based on social criteria should be matched out of state resources, an approach that is still being considered in 1999.

In November 1996, the Council created a committee of outside experts for the detailed review of housing subsidy policy. This Committee for Revising Housing Subsidies was authorized to collect data and perform analysis in all key areas of subsidy policy. It submitted an initial report in May 1997 and a final Report and Recommendations in February 1998. This report was supposed to be considered by the Housing Policy Council, but the government chose not to make public changes in housing policy in advance of the elections in May 1998.

In summary, the Committee concluded that there is no numerical housing shortage. Current subsidies that emphasize new construction need to be supplemented (and eventually supplanted) by matching grants to local governments that are targeted for assisting housing of low income households through whatever approach is most efficient and effective.

The operations of the Committee were a reflection of the improved policy making functions in the government of Hungary. Experts from the various interested parties and institutes were gathered and background studies in all four areas of focus of the Committee, (1) construction subsidies, (2) tax subsidies, (3) rental housing, and (4) rehabilitation, were prepared. The Committee then debated these and formulated recommendations, including noting any significant views not held unanimously.

In the run-up to the elections in May 1998, all the major parties emphasized their concern about the housing sector, and most promised to expand subsidies to the sector. After the elections, a coalition of three parties was installed and it was clear to them that the budget could not fund all of the election promises. It appears that the political and economic imperatives are doing the job of curbing the political impulses in this regard.

In this process, it was noteworthy that all of the civil servants previously involved in developing housing policy remain in their positions and contributed to efforts to limit the expansion in housing subsidies. There was a reorganization of housing policy making officially, with housing policy strategy shifting to the new Ministry of Economy, and the detailed regulation and budgeting staying in the Ministry of Finance. Fortunately, these two groups, which had been integrated, are still cooperating closely in the development of a number of new initiatives along the lines of the recommendations of the Committee of Experts.

Implementation of the DPM

The Deferred Payment Mortgage (DPM) was designed to maximize the amount of mortgage loan that a family could afford despite the high interest rates and despite a withdrawal of GOH subsidies. It did so by deferring a portion of the repayment for repayment at a later time, when inflation would have increased the household's nominal income. The degree of deferral was optional, but was set relatively low to avoid the required repayment from rising faster than incomes.

The DPM was implemented as a major option for borrowers through OTP in March 1994, shortly after the deep repayment subsidies previously offered by the GOH were ended. At that time OTP chose to portray the DPM as a special option that might be offered to borrowers who OTP branch staff felt were capable of understanding it and meeting the rising (nominal) repayments. Given the suspicious and strongly negative attitudes of the staff, it was relatively surprising that 800 DPM loans were eventually made in 1994. This was only 2 percent of all loans made by OTP for the purchase or construction of a house, but 8 percent of the loans for new houses and 11 percent of the total volume of lending for new houses.

This pattern of usage for new houses reflected a peculiar attribute of the situation in 1994. Borrowers who were buying a new house and expecting to have an additional child could have their loan paid down by the GOH at the time the additional child was born. Until November 1994, this additional amount was only HUF 150,000 for the second child and

HUF 400,000 for the third child, but interest on this amount from the time of the loan until the arrival of the child was also paid. Since it was likely that the balance on a non-DPM loan would be less than this amount (plus the accumulated interest), a DPM loan was preferable in these cases. The average size of a DPM on a new house started off much larger because the initial payment rate on the OTP version, 10 percent, was nearly two-thirds lower than the rate on the regular VRM (28 percent).

Two things happened in 1995 to change this situation somewhat. First, an extensive effort was made to change the attitudes of OTP branch staff towards the DPM. Second, the child-related subsidy was raised substantially, making the use of a DPM mandatory for a couple expecting to receive this subsidy at the birth of a child in the future.

The result was a 440 percent increase in 1995 in the use of DPMs by purchasers of new homes, rising to one-third of all loans made for new houses. Notably, the average size of a DPM for a new house was twice the amount of the average standard variable rate mortgage. The use of DPMs for existing homes also rose somewhat, by 87 percent, reflecting an increase in the acceptance of the concept. However, the DPM was used by less than one out a hundred buyers of an existing home (partly because several adverse underwriting standards employed by OTP keeps the advantage in terms of loan amount to less than 50 percent more). In total, DPMs constituted about 23 percent of the volume of OTP's lending for home purchases in 1995.

In 1996, 1997 and 1998, OTP made more (in volume) in DPM-type loans for new housing than in traditional subsidized annuity loans, because of the advantages when expecting to have additional children. The end of 1998 had closed more than 7,500 DPMs closed by OTP. There was also another 300 DPMs among the unsubsidized loans made for existing and rehabilitation (up from under 100 in 1996).

Despite this usage, it appears that most of the staff at OTP continued to either be under-informed about, or simply biased against, the DPM. The staff and the public have proven to be unwilling to value the advantages of being able to borrow more by deferring some of the repayment. This may partly reflect the general aversion of Hungarians to taking on long-term debt, an aversion revealed by data showing that 90 percent of homebuyers use no market-rate debt in their purchase.

Reforming GOH Housing Finance Subsidies

There were dramatic changes in 1994 with respect to GOH housing subsidy policy. As required under the HG agreement, mortgage subsidies were drastically reduced as of the beginning of 1994; loans for existing homes and most rehabilitation lost all subsidy and the direct subsidy for new houses was halved. In total, subsidies to mortgage loans declined by almost 70 percent.[1] This was a major accomplishment and has been critical for the GOH to bring its housing subsidy budget under control.

At first, the child-related lump-sum subsidy remained available at modest levels for new housing. Meanwhile, the previous exclusion of housing from the 25 percent Value Added Tax was partially removed in early 1993 and then fully removed as of November 1994. At the time of the termination of any exclusion of new houses from the VAT, the GOH attempted to recycle the funds raised from the VAT on housing into an expanded child-related lump-sum subsidy for new houses. The decision to focus nearly the entire subsidy on the second and third child caused these incremental subsidies to soar to HUF 1 million, a large sum relative to the cost of a house.

One of the most notable aspects of this subsidy, renamed the Housing Construction Allowance, was that it worked as lump-sum subsidies are supposed to. The beneficiaries could clearly see the benefits and reacted accordingly swiftly; the GOH was cognizant of the full cost of the subsidy and also acted relatively swiftly. The result was that the subsidy was extremely popular but was significantly truncated in May 1995 due to its large revenue losses.

After truncation, the HCA was primarily benefiting large, relatively lower income households living in rural areas, where few had bought a new house recently and construction was cheap (and fraud easier). In theory, this shift could be viewed as an improvement. Such direct grants are relatively efficient to administer and it was being targeted a socially desirable way, with most of the funds going to relatively lower income households. But tying funds to building new housing is not a sensible way of assisting lower-income housing and the grant's large size was generating disproportionate waste. Much of the funds were either going to people who would have built a new house anyway or to large families who already had access to a good existing house. Moreover, the new houses were often in villages with an excess of housing already. The waste was likely compounded by extensive fraud engendered by the large stakes involved.

In 1997, Hungary embarked on another foray into a major housing subsidy scheme, the Housing Savings Banks (HSBs). These institutions were modeled after the German and Austrian Bauspar system and have some attractions as a subsidy scheme and some major flaws. This observer and many others thought that the flaws exceeded the advantages and attempts were made to counter the plans to adopt this scheme, but various political and commercial interests succeeded in achieving enactment (albeit with better regulation and limits than in the Czech Republic and Slovakia).

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[1] This figure would have been greater than 80 percent if it were not for the enactment in 1994 of a tax credit applicable to repayments on mortgage loans for new houses. This subsidy combined with a reduced interest rate subsidy, kept the level of subsidy for such loans at two-thirds of the amount prior to 1994.

The Hungarian HSB system boils down to a state subsidy of the interest on savings (essentially the state subsidy allows people to get the market rate of interest on savings while the HSB pays only 3 percent) so the HSB can offer low rates on loans, i.e., the customer ultimately benefits in the form of a low rate (6 percent) loan. Its small advantage from the perspective of social policy over subsidizing loans directly is that it requires a certain amount of savings. However, buying a house in Hungary involves a large amount of savings anyway, so it is unlikely that this will mean much additional savings. Another advantage over the previous loan subsidies is that the (indirectly) subsidized loan can be used for any housing-related purpose, including rehabilitation. The big disadvantages are that the process of delivering the subsidy to households is incredibly wasteful and that there is no targeting of the benefits.

Because of the ongoing decline in inflation, the rate of return to saving under the contract was set higher than that available on alternatives. As a result, almost 300,000 contracts were concluded at the 1997 subsidy rates. Since the government did not cut the subsidy back in line with its official forecast of declining interest rates in 1998, the system has become recognized as a generally attractive vehicle for savings and likely to be very costly.

The GOH attempted to limit the promises made by HSBs so that the government would not be as subject to being politically “blackmailed” by the HSBs into expanding subsidies in order attract more savers later and bail out the HSBs with respect to their promises. However, the popularity of the HSBs in these early years may yet pose challenges to achieve a flow of new funds later capable of providing low cost loans to the early savers.

Despite the elevated HCA and HSB subsidy expenditures, the overall trend in real housing subsidy expenditures was downward from 1993 to 1999. To a great extent, this is because of the steady decline in the payments under previously committed subsidies. In particular, the subsidies on the loans originated prior to 1993 fell off sharply as interest rates came down, the passing of loans out of their period of deepest subsidy and the prepayment of many of them because of this event. However, the government has indicated that, as the burden of old subsidies declines, it intends to add new subsidies to the sector. It is in this context that the report of the Committee on Subsidy Reform can be valuable in deterring the adoption of additional inefficient and untargeted subsidies.

Managing Credit Risk

A market-based housing finance system places three primary risks as a lender: interest rate risk, liquidity risk, and credit risk. Credit risk, that with respect to timely repayment, was noted in 1993 as the major obstacle to the entrance of additional lenders into the housing finance market in Hungary.

In fact, the credit recovery situation of all lenders was in a state of suspended animation in 1993. Previous to then, OTP had garnished the wages of any delinquent borrower. However, the courts held in June 1992 that OTP could not do that without the permission of the employee. That left mortgage lenders only the right to seek recovery through enforcement of the mortgage itself. But the impossibility of effective eviction even after a lengthy foreclosure left housing lenders powerless to enforce the mortgage indenture. At the beginning of 1993, housing lenders essentially had no effective recourse in the case of default on the part of mortgage borrowers.

Since then, Hungary has adopted a number of progressive new laws to facilitate recovery of housing loans. As a result of recent changes in the legal framework, Hungary stands at the forefront of countries in Eastern and Central Europe in establishing the requisite legal tools for securing real estate loans and assuring expeditious access to collateral in the event of default in a mortgage loan. For example:

The 1993 Law on Regulation of Rent and Sale of Housing exempts private landlords from the requirement of providing alternative housing to an evicted tenant.

Amendments to the Civil Code sections on mortgages and liens adopted in 1996 and a 1994 law on court procedures permit foreclosure and repossession without the lengthy judicial proceedings required under previous law.

The Civil Code now permits the lender to sell the property itself without court intervention if the parties so agreed in the loan documents.

Civil Code amendments provide that for residential real estate, the parties may agree that the borrower must deliver the property empty of occupants in the event of foreclosure.

The 1997 Law on Mortgage Banks and Mortgage Bonds changed the priority for payment to a mortgage lender from the proceeds of a foreclosure sale from last place to fourth place, ahead of taxes, social security, and other public debt.

Unfortunately, this extensive legal support structure has not been substantively tested in concrete instances. Moreover, these significant developments do not seem to have made a substantial difference in actual real estate lending and recovery practices used by Hungarian banks. For example, the available data strongly suggest that OTP made no reduction in its delinquencies from 1993 to 1997. Tracking loans on a cohort basis (something which OTP management has continually resisted) indicates that, among loans made 3 years previously, the rate of delinquency over 6 months or 1 year remains as high as in 1993.

As noted, the banking communities, and especially OTP, have not been aggressive about utilizing the full range of tools available to them under the new laws. Some bankers believe other remedies, such as renegotiating loan terms or seeking payment from guarantors, are preferable because they are less problematic, even if they are insufficiently effective. In addition, non-judicial foreclosure is available only if the loan documents are notarized, and this procedure is quite expensive. It appears that the only tool that may force a change in this regard is enough competitive pressure on excessive margins that lenders will act to reduce costs from defaults.

Some confirmation of the continuing political sensitivity of default enforcement has appeared in the handling of the first set of loans to be eligible for reimbursement under the government's guarantee of the pre-1989 loans. It has taken 5-7 years, but all legal procedures have been completed and OTP has wanted to cash in on the MOF guarantee of these old loans by following through with sale and eviction. This created some controversy, mostly through the efforts of those being evicted to publicize their situation. For a while, it seemed that the focus of the criticism was the foreclosure procedures themselves. Changes made in these could have undone a lot of the careful work to create an environment supportive of loan recovery. Instead, the net result of these pressures was a declaration of a moratorium by the GOH and OTP in going to eviction in such cases, until after the elections. It is not known what the resolution of this issue has been since the election.

Sounder Lending Practices

This area has been slow to show marked improvement over time. This partly reflects the low level of mortgage lending overall since 1993, the withdrawal of emphasis on this area within OTP, and the delays in privatization of banks. Now that the banking sector has generally been privatized to strategic foreign investors, there should be acceleration in the movement towards a more business-like mode of operation. Already, several banks are attempting to apply modern professional methods to this area. Also, in adopting the DPM, OTP did explicitly evaluate the greater risks involved in the loan and specify more conservative underwriting criteria for it. Moreover, banking regulators are now requiring proper write-offs for delinquent loans, giving OTP full incentives to employ sound underwriting and delinquency management techniques.

One important area for this is efforts to collect credit history information. Unfortunately, OTP’s monopoly position in the past has prompted it to decline to cooperate in such an endeavor, preferring to retain all information on past performance of borrowers.

It would also be desirable to see the improved access to housing collateral be applied to liberalizing some aspects of underwriting. In particular, if improved access to foreclosure and eviction reduces credit risks, they should reduce the requirements for guarantors, expand the allowable ratio of loan repayment to income and possibly accept less formal evidence of gray market income.

Credit Enhancement Structure

The GOH has often stated an intention to consider creating a "loan guarantee institution" and in fact it continues to provide an 80 percent guarantee on loans eligible for government subsidy (essentially on new houses). Fortunately, it has chosen to not proceed further in this direction. A contribution by USAID TA to the debate over such a guarantee institution was prepared in January 1997, which concluded that the disadvantages of such a guarantee institution are significantly greater than the advantages. The recent political controversy over enforcing foreclosure in the case of pre-1989 loans made by OTP supports the conclusion that governmental involvement will only make creation of a strong repayment “culture” more difficult.

On the other hand, the same event confirms the fears of the banks about their loss of reputation from strong enforcement. To deal with this, it has been suggested an independent but government-sponsored "guarantee" institution could be created to provide “cover” for the lenders, but which would charge each bank for any losses the bank imposes on it. This would retain the advantage of reducing the negative publicity that a bank might endure from a foreclosure while reducing the moral and political hazards of a true general guarantee.

Accessing Long-Term Funds

Throughout the period, there have been expressions of concern that the deposit base of banks was not an appropriate basis for a market-based housing finance system. This view was one of the impetuses for lengthy work on a law on mortgage bonds. A general mortgage banking law was passed in April 1997. As was planned, a government-sponsored institution, the Land and Mortgage Bank (FHB in Hungarian), was immediately set up to engage in refinancing loans secured by agricultural land, with operations likely to start in 1999. However, this institution has already indicated that it may go into mortgage banking for housing loans, as well loans for commercial real estate and municipal infrastructure.

It also appears that OTP and one or two German entities are considering the mortgage bank approach to fund raising. However, it is this observer's expectation that they will not find it possible to compete with the commercial banks without special subsidies of the kind being provided in the Czech and Slovak Republics. The main issue is how much spread the market will want on the bonds, over the rate on government bonds. The FHB is hoping that they can start with spreads of only 30-50 basis points, almost as low as for German mortgage banks. However, the fact is that the credit risks are not negligible, in the absence of a GOH guarantee, and such bonds are effectively illiquid. Any spread higher than this, however, probably makes such funds more expensive than deposits.

In theory, however, using deposits poses various liquidity risks for banks. In practice, though, the deposit bases of most banks are stable enough to easily accommodate the investment of 10-20 percent of their portfolio in long-term mortgages. Moreover, given the current very low levels of mortgage origination, such levels will not be exceeded anytime in the near future.

Despite this, the GOH, partly due to its large investment in the FHB, may succumb to the temptation to subsidize mortgage bond funding. The Czech Republic and Slovakia have already done so, but Hungary has so far refused to. Alternatively, Hungary should also examine taking the approach used in the other countries of incorporating mortgage banking into regular commercial banking, allowing mortgage bond issuance as one way for commercial banks to raise funds if and when the cost is competitive.

Competition with OTP

The domination of the housing loan sector by OTP has been seen widely as stunting the development of the sector. This stunting was accentuated by the slow process of its own internal restructuring as a dynamic private enterprise, given its privileged position of not being privatized to a strategic investor. Unfortunately, the long process of bank privatization and revitalization also delayed the entry of serious competition in the mortgage market. Although it accelerated in 1996-7, a result has been a number of banks in organizational flux.

Overall, it appears that Hungarian bankers today perceive banking as necessarily encompassing an aggressive retail posture, at least at the top end of the retail market and including an active housing lending program. This "can-do" attitude towards retail banking stands in sharp contrast to the hesitant moves taken previously by the large banks with a base in commercial lending (for the good reason that they did not have the capital base and expertise to move aggressively into this area).

This was reflected in a survey conducted in 1998 of all of the banks with respect to their interest in a training session on housing lending. Out of 33 banks contacted, 18 expressed some interest, 7-8 of these seemed to be strongly interested and 3 of these are already active.

A major pending issue, though, is whether the success of the HSBs will undermine the potential market for regular housing loans. To some extent, the answer must be yes, since the total available to a couple completing a four-year contract will be about HUF 2.6 million, and this will leave most households with no additional borrowing capacity. This could stunt the development of the housing finance system by pushing it into a special circuit that would be separated from the main financial markets. An alternative view might be that it is mostly the households, which formerly borrowed for renovations from OTP before the end of subsidies in 1994 who are planning to take advantage of the subsidized HSB loans. More evidence on this should soon be available in the Czech Republic, where many HSB accounts are maturing and HSB loans will be competing directly with loans from commercial banks.